No. 77-1303

# In the Supreme Court of the United States

OCTOBER TERM, 1977

SUN OIL COMPANY, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.,
*Solicitor General,*
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The question in this case is whether a two-party sale and leaseback transaction actually constituted a secured financing arrangement for federal tax purposes.

1. The undisputed facts are as follows: Petitioner is the successor to the Sunray DX Oil Company (Sunray), an integrated oil company that was engaged during the years here in question (1965-1968) in all phases of the petroleum business. Beginning in the early 1960's Sunray embarked upon an acquisition program to expand its service station marketing sites. In the course of this program, the company acquired a large number of parcels of unimproved land located along interstate highways and in certain urban areas. Title to several hundred of these service station sites was then transferred under two sale and leaseback agreements to the General Electric Pension Trust, a

fiduciary trust qualifying for exemption from federal income taxes under Sections 401(a) and 501(a) of the Internal Revenue Code of 1954, as amended (26 U.S.C.) (Pet. App. 2a-3a). Under the first agreement, dated October 13, 1964, the trust agreed to purchase approximately 120 of these sites at Sunray's cost for an aggregate amount not to exceed $6,000,000. Sunray agreed, at the same time, to lease each parcel back from the trust for a term of 25 years at rentals designed to amortize the trust's outlay at an agreed annual interest rate of 4 5/8 percent.[1] A similar agreement covering the remaining parcels was executed on April 24, 1967, providing for an aggregate purchase price not to exceed $11,000,000 and an annual interest rate of 5 3/8 percent (Pet. App. 13a-14a). Sunray's obligation to pay the agreed rentals over the primary term was absolute and unconditional. It also agreed to pay all taxes, insurance, and other expenses on the properties, and it bore all risks of loss (Pet. App. 14a, 20a-21a).

The lease agreements under both arrangements further provided Sunray with the option to reacquire title to the parcels by paying off the unamortized balance of the trust's outlays. If, during the primary term, Sunray determined that it would discontinue "its then business use" of a particular property, or if it determined that continued leasing was "unprofitable or unreasonable or unnecessary," it could make a rejectable offer to repurchase the property for a price equal to the unamortized balance of the trust's advance on that property, plus a specified premium sufficient to increase

[1]Pursuant to the agreements, Sunray and the trust executed master leases covering each of the individual parcels of land. A "Schedule of Direct Reduction Loan" was attached to the master leases for each parcel containing a specific allocation of the "rentals" to principal and interest for each payment to be made by Sunray during the 25 year amortization period (Pet. App. 27a; Exs. 12-J, 31-AC).



the trust's overall return to 5 1/2 or 5 3/4 percent (Pet. App. 3a-6a). As of the date of trial, Sunray had regained title to over one-third of the properties in question pursuant to this provision (Pet. App. 16a).[2]

In addition, in lieu of making a rejectable offer, Sunray also had the absolute right to substitute other parcels having a book value at least equal to the rejectable offer price for the property in question (Pet. App. 15a, 23a). Finally, Sunray retained the right during the extended terms of the leases, upon discontinuing its then business use of a particular piece of property, to reacquire title to that property for a price equal to the "fair appraised value * * * to Lessor" (Pet. App. 29a). The evidence at trial showed that the parties intended this price to reflect the value of the property as encumbered by the favorable leases, providing Sunray with substantially reduced rentals during the extended terms (Pet. App. 30a n. 12).

On its corporate income tax returns for 1965 through 1968, Sunray claimed deductions under Section 162(a)(3) of the Internal Revenue Code for rental payments made to the trust pursuant to the sale and leaseback agreements. On audit, the Commissioner of Internal Revenue disallowed Sunray's claimed rental deductions.[3] The Tax Court upheld the deductibility of the rental payments to the trust (Pet. App. 1a-9a). The court of appeals reversed (Pet. App. 10a-33a). Relying on this Court's decision in *Helvering* v. *Lazarus & Co.*, 308 U.S.

[2]Although the trust theoretically retained the right to reject an offer to repurchase, the evidence at trial showed that it accepted the offers as a routine matter and had never exercised its theoretical option to reject any repurchase offer (Pet. App. 24a).

[3]The Commissioner did allow Sunary to deduct that portion of each payment reflected as interest under the "Schedule of Direct Reduction Loan" attached to each lease as interest paid under Section 163 of the Internal Revenue Code (Supp. Stip. of Facts, p. 52).

252, the court of appeals held that the sale and leaseback transactions were simply secured financing arrangements and that the payments made in connection with the transactions were therefore not allowable deductions under Section 162(a)(3) of the Code.

2. In *Frank Lyon Co.* v. *United States*, No. 76-624, decided April 18, 1978, this Court addressed the question of the tax treatment of various sale and leaseback arrangements. The *Frank Lyon Co.* case itself concerned a three-party transaction involving the sale and leaseback of a bank building. The Court examined the transaction in light of the decision in *Helvering* v. *Lazarus & Co.*, 308 U.S. 252, and concluded that the presence of the third party in the arrangement "significantly distinguishe[d]" the case from *Lazarus*. Accordingly, the Court held that the sale and leaseback arrangement in that case was a *bona fide* leasing arrangement for federal tax purposes. *Frank Lyon Co.* v. *United States*, *supra*, slip op. 14. In the course of its opinion, the Court reaffirmed the vitality of *Lazarus* as the controlling authority applicable to classic two-party sale and leaseback transactions such as the one in the present case. *Id.* at 13-14. Indeed, in distinguishing the tax avoidance features of the transaction in this very case from that in *Frank Lyon Co.*, the Court observed that the purported sale and leaseback between Sunray and the tax-exempt trust enabled Sunray "to amortize, through its rental deductions, the cost of acquiring land not otherwise depreciable." *Id.* at 22 n. 18. The decision of the court of appeals is therefore squarely in accordance with the applicable decisions of this Court. See also Kaster, *Sale-Leasebacks: Effect on Net Leases of the Sun Oil Company Loan-or-Lease Criteria*, 48 Journal of Taxation 194 (1978).



3. Citing *Commissioner* v. *Duberstein*, 363 U.S. 278, petitioner argues (Pet. 4-8) that the court of appeals improperly disregarded the factual findings of the Tax Court in reaching its conclusion. The court of appeals, however, made no factual redeterminations. Instead, it disagreed with the Tax Court's legal characterization of the transaction for federal tax purposes (Pet. App. 17a-18a, 31a). In this respect, the decision below is in accord with this Court's decision in *Frank Lyon Co.* and with the decisions of other circuits that have uniformly held the characterization of such financing arrangements to be a legal rather than a factual question. *Frank Lyon Co.* v. *United States*, *supra*, slip op. 20 n. 16; *American Realty Trust* v. *United States*, 498 F. 2d 1194, 1198 (C.A. 4); *Union Planters National Bank of Memphis* v. *United States*, 426 F. 2d 115, 117-118 (C.A. 6), certiorari denied, 400 U.S. 827; *Estate of Franklin* v. *Commissioner*, 544 F. 2d 1045, 1047 n. 3 (C.A. 9).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
*Solicitor General.*

MAY 1978.

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